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Conflicts of Interest (Part 4): Managed Accounts and Avoiding

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Prohibited Transactions

BY FRED REISH, JOAN NERI, AND JOSHUA WALDBESER

This article is the fourth in a series that examines conflict of interest issues under the prohibited transaction rules of ERISA and the Internal Revenue Code and focuses on the prohibited transaction that could arise when service providers, including broker-dealers, registered investment advisers, and their representatives who are already acting in a fiduciary capacity to private sector retirement plans also recommend their managed account services for participants in those plans.

This is our fourth article in a series that examines conflicts of interests that are prohibited transactions under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the Code). In this article, we focus on the prohibited transaction that could arise when service providers, including broker-dealers, registered investment advisers, and their representatives who are already acting in a fiduciary capacity to private sector retirement plans (that is, as "plan-level" nondiscretionary investment advisors or discretionary investment managers, collectively referred to as "fiduciary advisors") also recommend their managed account services for participants in those plans.

As we discuss further below, unless the conditions of Prohibited Transaction Exemption (PTE) 2020-02 are satisfied, a fiduciary advisor cannot (when acting in a fiduciary capacity) recommend himself or herself as a participant-level investment manager and receive an additional fee for that managed account service because that constitutes a non-exempt prohibited transaction (PT). Similarly, absent PTE relief, a fiduciary advisor cannot recommend an affiliate-managed account service for which the affiliate receives a fee, because that too would constitute a non-exempt PT. For simplicity, in this article any references to "fiduciary advisors" are intended to include not only the individual advisor, but also the firm and any affiliates. Likewise, references to "plan sponsors" also include officers, committee members, or other plan fiduciaries.

There are a number of ways that advisors can avoid violating the PT rules in this manner, but it is important for advisors to understand what approaches are permissible and proceed accordingly. Also, plan sponsors should be aware of these PT issues and certain additional considerations when considering offering a managed account service under the plan.

Background

A fiduciary advisor, as defined in ERISA and applicable regulations, generally is prohibited from using his or her fiduciary status to cause themself or their affiliate to receive additional compensation from the plan or to receive compensation from a third party in connection with transactions involving plan assets (for example, from providers or investments). [ERISA §§ 406(b)(1), 406(b)(3)] This is referred to as the "fiduciary self-dealing rule." The Code has a virtually identical rule that applies not only to qualified ERISA plans, but also to Individual Retirement Accounts (IRAs) and non-ERISA qualified private sector plans, such as solo 401(k) and Keogh plans. For purposes of this article, we will focus on recommendations by fiduciary advisors to ERISA plans.

Under the fiduciary self-dealing rule, a fiduciary advisor to a plan is prohibited from recommending a proprietary fund, that is, an investment fund managed by the fiduciary advisor or the advisor's firm or an affiliate that pays the advisor an additional management fee. The Department of Labor (DOL) has issued guidance indicating that the recommendation of an investment manager is considered to be the same as the recommendation of an investment. [*See* DOL Advisory Opinion 84-04A; *see also* the Preamble to 29 CFR § 2510.3-21(c), 74 Fed. Reg. 3822, 3824 (January 21, 2009) and In re Beacon Associates Litigation, 745 F. Supp. 2d 386, 423-4 (S.D. N.Y. 2010)] Therefore, a fiduciary advisor cannot receive an additional fee for recommending an investment manager, if the recommendation is made in a fiduciary capacity. This means that, if a fiduciary advisor to the plan recommends the advisor's managed account service or the managed account service of an affiliate and it results in receipt of a management fee by the advisor or its affiliate, it may be a self-dealing transaction and the management

fee would be prohibited. A self-dealing issue could also arise if the fiduciary advisor advises participants to use the managed account service if that would increase the advisor's fees. Another example of self-dealing is where the fiduciary advisor receives additional compensation for providing recommendations on monitoring himself or herself as the manager.

However, it is important to understand that a violation of the fiduciary self-dealing rule will only occur if a fiduciary uses the "authority, control or responsibility" that makes it a fiduciary to receive additional fees. The DOL illustrates this concept in an example set forth in its Q&A guidance. In the example, the DOL explains that, when a fiduciary advisor recommends to a plan sponsor that the advisor be hired to perform portfolio evaluation services for an additional fee (in addition to the investment advisory services already being provided), this is not an act of self-dealing "because [the advisor] did not use any of the authority, control or responsibility which makes [the advisor] a fiduciary (the provision of investment advisory services) to cause the plan to pay [the advisor] additional fees for the provision of the portfolio evaluation services." [DOL Reg. § 2550.408b-2(f)—Example #1]

Managed Account Service Offerings That Avoid a Prohibited Transaction

There are several ways that advisors can avoid a PT when offering managed account services.

"Hire Me" Discussions

A fiduciary advisor to a plan or a participant generally can engage in a "hire me" discussion about the advisor's managed account service and this will not be considered ERISA fiduciary advice and, therefore, will not result in self-dealing. This is because marketing one's own services generally falls outside the scope of the DOL's definition of a fiduciary investment recommendation.

In the Preamble to PTE 2020-02, the DOL acknowledges that marketing one's own services is not investment advice:

> [T]he Department does not believe that there should be significant concerns about introductory "hire me" conversations. This is because all prongs of the five-part test must be satisfied for a financial services provider to be considered a fiduciary. Nevertheless, the Department confirms that the interpretive statements in this preamble are not intended to suggest that marketing activity of the type described above would be treated as investment advice covered under the five-part test. [Preamble to PTE 2020-02, 85 Fed. Reg. 82798 at page 82809 (December 18, 2020)]

However, it is important to understand the distinction between general "hire me" communications and fiduciary advice. By "hire me," we mean communications describing an available service in a general way, including the advisor's experience and capabilities, perhaps even with some "puffing," that is, "marketing-type" communications that are not specific to particular investments or the needs of particular plans or participants, and which would not reasonably be understood by the communication recipient as a basis upon which to make specific investment decisions. To illustrate the distinction, recommending to a participant a specific proprietary investment strategy offered by the fiduciary advisor as being particularly appropriate for that participant's needs is likely to "cross the line" into fiduciary advice and may trigger self-dealing concerns.

Therefore, the advisor can describe its managed account services generally to a prospective plan sponsor client and even tout those services, and this conduct alone will not cause the advisor to be an ERISA fiduciary subject to the self-dealing restrictions. In turn, a plan sponsor can hire an advisor to provide an array of services, such as, plan-level services (for example, recommending and monitoring the plan investment options) and participant-level services (for example, providing the managed account service), without engaging in a PT under the self-dealing rule.

In situations where an advisor may market additional services to the plan sponsor after it has been engaged, it may even be advisable for the advisor to state specifically in its advisory agreement that such marketing is permissible, and the plan sponsor acknowledges and agrees that such marketing communications are outside the scope of the advisor's fiduciary responsibility and should not be regarded as investment recommendations upon which specific investment decisions may be made.

Education About the Managed Account Service

If the advisor is an ERISA fiduciary to a plan and provides unbiased educational-type information to the plan sponsor about the advisor's additional services, including the managed account services, this, by itself, is not fiduciary advice. If the plan sponsor then decides to offer the managed account services to participants, there would not be a self-dealing transaction because the fiduciary advisor did not use its authority

as a fiduciary to recommend itself to the plan sponsor. Rather, the advisor merely provided the plan sponsor with objective information about the service to assist the plan sponsor in making the decision.

Adviser is a Fiduciary but Charges No (Additional) Managed Account Fee

If, on the other hand, the advisor is an ERISA fiduciary to the plan receiving a plan-level advisory fee and then recommends his or her managed account service, the advisor can avoid a PT if the advisor charges no additional fee for providing the managed account service. This would not be self-dealing because the advisor is not receiving any compensation beyond his or her plan-level advisory fee. In that instance, the investment advisory agreement should clearly state that providing the managed account service will not result in additional compensation to the advisor. This would also include situations in which the managed account service is part of the overall service package established at the outset of the relationship, in which case all of the services to be provided by the fiduciary advisor may be taken into account in arriving at the agreed-upon total fee.

PTE 2020-02

Another option to avoid a PT is for the fiduciary advisor to rely on PTE 2020-02. PTE 2020-02 relief is available if the advisor's recommendation is nondiscretionary and certain requirements are met. Here, the recommendation would be nondiscretionary because the plan sponsor (or the plan participant, in the case of a third-party advisor who has not been engaged to provide plan-level services) would be making the ultimate decision as to whether to engage the advisor to provide the managed account service. The PTE includes a number of conditions that we discussed in detail in the first two parts of this article series, including adherence to a best interest standard, disclosure obligations, policies and procedures to ensure compliance, and an annual retrospective review of compliance reduced to a written report.

Plan Sponsor Considerations

In addition to these PT issues, there are a number of considerations for a plan sponsor that is considering offering a managed account service under the plan, described further below.

ERISA Fiduciary and 3(38) Investment Manager

A managed account service is a customized discretionary investment management service. In providing the managed account service, the advisor is a fiduciary under ERISA and a Section 3(38) investment manager with respect to the managed assets. As such, the advisor will need to adhere to the ERISA fiduciary duties of prudence and loyalty in managing the participant's account assets. The plan sponsor should inquire as to the advisor's investment process to ensure that it is prudent. For instance, a prudent advisor would obtain relevant information about the participant (for example, risk tolerance, investment objectives, and financial needs) to develop an investment strategy that aligns with the participant's needs. The plan sponsor should also ensure that the advisor's fee for the managed account service is reasonable as based on fees charged in the competitive marketplace for that service.

In addition, when the plan sponsor has selected an advisor to provide a participant account management service, the plan sponsor needs to prudently monitor the services on an ongoing basis; as the DOL explained in Field Assistance Bulletin 2007-01 (Q&A #2):

> In monitoring investment advisers, we anticipate that fiduciaries will periodically review, among other things, the extent to which there have been any changes in the information that served as the basis for the initial selection of the investment adviser, including whether the adviser continues to meet applicable federal and state securities law requirements, and whether the advice being furnished to participants and beneficiaries was based upon generally accepted investment theories. Fiduciaries also should take into account whether the investment advice provider is complying with the contractual provisions of the engagement; utilization of the investment advice services by the participants in relation to the cost of the services to the plan; and participant comments and complaints about the quality of the furnished advice. With regard to comments and complaints, we note that to the extent that a complaint or complaints raise questions concerning the quality of advice being provided to participants, a fiduciary may have to review the specific advice at issue with the investment adviser.

We also should point out that there is an important distinction between participant account managers who are selected by plan sponsors and are made available to plan participants generally (which are referred to as designated investment managers or DIMs) and wealth managers or other advisers who have no relationship with the plan generally, but rather are hired directly by individual plan participants. As the DOL has explained:

> A designated investment manager ("DIM") is a section 3(38) investment manager that is designated by a plan fiduciary and made available to participants and beneficiaries to manage all or a portion of the assets held in, or contributed to, their individual accounts. When participants appoint a DIM to manage all or a portion of their individual accounts, the DIM becomes responsible for investing their accounts on a participant-by-participant basis. The regulation does not impose any limitations on the investment alternatives that a DIM may use for investing participants' and beneficiaries' accounts. However, a plan may impose limitations by its terms or in its agreement with the DIM (e.g., the DIM may only invest in a plan's designated investment alternatives). [Field Assistance Bulletin 2012-02R, Q&A #4]

On the other hand, the DOL also has made clear that plan sponsors have no fiduciary responsibility or liability at all in cases where an advisor is engaged entirely by an individual plan participant for the participant's own account, with no involvement of the sponsor:

> [I]n the context of an ERISA section 404(c) [participant-directed] plan, neither the designation of a person to provide education nor the designation of a fiduciary to provide investment advice to participants and beneficiaries would, in itself, give rise to fiduciary liability for loss, or with respect to any breach of part 4 of title I of ERISA, that is the direct and necessary result of a participant's or beneficiary's exercise of independent control. 29 CFR 2550.404c-1(d). **The Department also notes that a plan sponsor or fiduciary would have no fiduciary responsibility or liability with respect to the actions of a third party selected by a participant or beneficiary to provide education or investment advice where the plan sponsor or fiduciary neither selects nor endorses the educator or advisor, nor otherwise makes arrangements with the educator or advisor to provide such services.** (Emphasis added) [Interpretive Bulletin 96-1, Section (e)]

Disclosure Obligations

An advisor selected by the plan sponsor (for example, a DIM) is obligated to provide an ERISA Section 408(b)(2) disclosure to the plan sponsor in advance of the engagement describing the advisor's compensation, services, and status as an ERISA fiduciary and registered investment adviser. Many advisors include this disclosure in their service agreements. The plan sponsor should review these disclosures and the overall service arrangement and fees to ensure that they are reasonable. The DOL does not specifically require that a similar disclosure be made to the participants. However, as a best practice, many advisors provide a similar disclosure to participants, along with the advisor's Form ADV, Part 2, or similar brochure. The plan sponsor should inquire and find out whether the advisor will be providing a disclosure to participants.

For a wealth advisor or similar advisor selected solely by a plan participant for his or her own account, while DOL guidance has not addressed this permutation specifically, the assumption should be that the participant is the "responsible plan fiduciary" for purposes of ERISA Section 408(b)(2), and thus should receive the same disclosures a plan sponsor would receive from a plan-level DIM (in addition to any required Form ADV disclosures). We generally recommend this because, in our view, a participant-selected advisor is still providing a service in an ERISA fiduciary capacity (even if only with respect to one participant's account) and, therefore, could be considered a "covered service provider" that is subject to the 408(b)(2) disclosure obligation.

Services

To provide a competitive edge, some advisors offer services in addition to the managed account service. These additional services may include retirement distribution planning, retirement readiness projections, savings rate guidance, and Social Security benefit guidance. The plan sponsor (or the participant, in the case of a participant-selected advisor) should consider these additional services in evaluating the reasonableness of the advisor's compensation.

QDIA Status

If the plan sponsor is considering using the managed account service as the qualified default investment alternative (QDIA) for participants who fail to make an investment election, then the managed account service must satisfy requirements set forth in the DOL regulations. These requirements are that:

- The advisor manages the assets consistent with generally accepted investment theories (for example, model portfolio theory);

- The advisor invests only from among the plan's designated investment alternatives and does not use investments outside the plan line-up;
- The advisor allocates among equity and fixed income investments based on the participant's age, target retirement date or life expectancy; and
- The investments are diversified to minimize the risk of large losses with the objective of becoming more conservative with the participant's increasing age. [DOL Reg. § 2550.404c-5(e)(4)(iii)]

The plan sponsor also must provide the participants with notices about the QDIA, including a description of the managed account service.

Conclusion

Managed account solutions can provide participants with an additional opportunity to improve investment outcomes. Advisors who wish to make available a managed account solution should either negotiate this service (and any resulting fees) at the outset of the relationship, or, for existing plan clients, should be careful that they are not making fiduciary recommendations that would increase their fees, unless they are relying on PTE 2020-02.

Plan sponsors who are considering offering a managed account solution also should be aware of these PT issues and related considerations in evaluating the fiduciary advisor's services and fees. ■